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ASSISTANT SECRETARY

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MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

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SUBJECT: Debt Problems of LDCs and East European Countries

A Working Group of the CCEA was established last September to examine the financial problems of developing countries -- especially the rapid growth of LDC debt. At the Group's first meeting, it was agreed to extend the scope of the Group's work to the debt situation in East Europe.

The Working Group has completed an initial survey of the LDC and East European debt situations, and of relevant U.S.G. policies and procedures. Highlights of this survey are summarized in the following sections.

The Dimensions of LDC Debt

The total external debt of 143 LDCs amounted to $489 billion at the end of 1979. Four-fifths of the total was long-term debt. The external debt of the non-oil LDCs grew at an average annual rate of 22% during the 1970s -- or 6-9% after adjusting for inflation. The growth of debt is estimated to have been somewhat slower in 1980 and 1981.

Debt service payments for the non-oil LDCs grew more rapidly (28% nominal) during the decade, reflecting a shift toward borrowing from private lenders that entailed shorter maturities and higher interest rates. The aggregate ratio of debt service to exports rose from 16% in 1970 to 19% in 1979. However, the ratio of debt outstanding to exports declined from 126% to 109%.

LDC debt is highly concentrated among a small group of LDCs which are either oil exporters or major exporters of manufactures. Ten countries account for 50% of the long-term debt of all 143 LDCs. These are Brazil, Mexico, Algeria, India, Indonesia, Korea, Yugoslavia, Argentina, Egypt and Turkey.

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The Dimensions of East European Debt

The total external debt of the USSR and five other East European countries rose from $11 billion at the beginning of the 1970s to roughly $81 billion at the end of 1980 (22% per annum). Three countries -- Poland, the USSR and the GDR -- account for two-thirds of the total.

After Poland, the countries with the weakest debt-servicing capacity are Romania and Yugoslavia (a non-Soviet bloc country). Romania has recently taken initial steps to obtain debt relief from official and private creditors. Yugoslavia might have to resort to debt relief if its access to private capital markets is seriously affected either because of reluctance on the part of private lenders to lend to East Europe generally (due to the Poland situation), or because of further delays in improving its economic performance.

In general, their desire to maintain access to western capital is expected to force the East European countries in the next few years to cut back on investment, consumption, or both, in order to maintain or strengthen their creditworthiness.

Debt Servicing Difficulties

Three degrees of debt-servicing difficulties can be distinguished: mild, serious and critical. Critical difficulties are indicated by the country's decision to seek debt relief.

An IMF analysis of the causes of debt-servicing difficulties included several notable points: (a) the difficulties evolved over a period of several years; (b) the single most important cause was the adverse impact of fiscal and monetary imbalances on the external sector, especially through rapid import growth; and (c) the imbalances were often related to ambitious development plans or social/political pressures. (There is evidence that another important cause was political instability. Soaring oil prices have also had an important impact, of course.)

Policies and Procedures

Since World War II the international community has developed relatively effective ad hoc procedures for assisting countries experiencing debt-servicing difficulties. The IMF plays a central role in these procedures. The procedures followed by official creditors, as embodied in the "Paris Club", are more standard and more formal than those followed by private creditors (especially commercial banks). For a variety of reasons, typical terms for official debt-relief arrangements are consistently different from those for private arrangements.

U.S. policies on extending debt relief to foreign countries spring from the broad responsibilities of the Executive Branch and from the legislation establishing specific foreign credit programs.

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In a 1970 opinion, the Attorney General concluded that the Executive Branch has considerable flexibility in modifying loan repayment terms, especially when the borrowing country is in a situation of default or imminent default. There is substantial Congressional interest in U.S. debt policy which is reflected in provisions of several authorization and appropriations acts.

Since 1970, the USG has adopted relatively rigorous procedures for identifying and eliminating delinquent payments. There is a formal reporting system that supports these procedures. The principal interagency body concerned with these procedures is the National Advisory Council (NAC) on International Monetary and Financial Policies.

In 1978, the NAC adopted a statement of U.S. policy on debt reorganization. The Treasury Department and the State Department have a joint responsibility for USG participation in debt-relief negotiations --in collaboration with the creditor agencies concerned.

U.S. Exposure

U.S. Government exposure in the LDCs at the end of 1980 amounted to $40 billion associated with direct credits and $13 billion with guaranteed credits. USG exposure on direct credits is heaviest in Israel, Egypt, India, Korea, Pakistan, Brazil, and Indonesia. (All over $2 billion.)

Arrearages on all post-WWI USG foreign credits at the end of 1980 were close to $1 billion, but 83% of these were "extraordinary political arrearages" (Cuba, Iran, Vietnam, etc.). The budgetary impact of the shortfalls resulting from debt-relief agreements is significant. For FY 1981, these shortfalls have been estimated at around $700 million (including $285 million for Poland).

The exposure of U.S. banks in non-oil LDCs at the end of 1980 was $111 billion. Just four countries (Mexico, Brazil, Korea and Argentina) accounted for 50% of U.S. bank exposure. Sixty percent of the banks' claims on non-oil LDCs had a remaining maturity of one year or less.

Initial Policy Issue

Among the major policy issues that have surfaced so far, the Group concluded that the first issue to raise with the CCEA should be the issue of "comparable treatment" of private and official creditors in debt-rescheduling operations.

USG policy seeks to ensure that debt-relief extended by the USG does not serve to "bail out" private creditors. However, some U.S. bankers have argued that this policy of "comparable treatment" is unfair and conflicts with the USG policy of non-interference in the commercial decisions of private banks. The Working Group has examined the economic arguments for and

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against comparable treatment, and has considered the possibility of defining comparable treatment more precisely. The group has also considered the application of current policy in the specific cases of Poland, Romania, Sudan and Zaire in recent months.

The Group has concluded that: (a) current policy on comparable treatment should be maintained; (b) the vagueness of the term "comparable treatment" provides needed flexibility in the application of U.S. policy; (c) USG policy on non-interference in the commercial decisions of private banks encompasses decisions on debt relief; and (d) in specific cases where innovative approaches to debt relief may be justified, comparable treatment should remain as an objective.

A separate memo on comparable treatment accompanies this one.

Other Policy Issues

A. Official Credits

1. USG agencies have repeatedly extended or guaranteed new loans to countries with significant external arrears. Other governments have behaved similarly. Often, financial concerns are overridden by political interests abroad or by domestic pressures to promote exports. Sometimes such lending can exacerbate debt-servicing difficulties, thereby undermining the political or export objectives in the long run. Are there new policies or financing techniques that would avoid the pitfalls of the current practices?

2. The conventional "Paris Club" and "London Club" approach to debt relief has been effective in many cases. Recently, however, the results have been unsatisfactory in countries that have had "prolonged" debt problems, such as Sudan, Turkey and Zaire. Are there alternatives to rescheduling (e.g., moratoria and special balance of payments loans) or unconventional approaches to rescheduling that should be considered in special cases?

3. Eximbank and OPIC have sought "preferred creditor status" in debt rescheduling situations -- by establishing off-shore escrow accounts, for example. In addition, USG lending agencies have recently adopted a more market-oriented basis for charging interest on their rescheduled loans. This has created some inconsistencies between agencies. Also, it substantially reduces the value of the debt-relief provided. Are modifications called for in the present practices of USG lending agencies regarding debt-relief?

B. Private-Sector Credits

Relationships between governments and commercial banks vary from country to country, and appear to have an important bearing on how creditor countries respond to requests for debt relief. This factor may have contributed to difficulties in arriving at a consensus among creditors on the timing, form and terms of debt relief in specific cases -- and on the provision of new credits. Are there steps the USG can take to encourage other governments

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to adopt more market-oriented and financially sound approaches to debt relief and to the extension of new credits to countries experiencing serious debt-servicing difficulties?

C. The Roles of the International Institutions

1. The MDBs have been exempt from participation in multilateral rescheduling operations. There are a number of countries, however, whose debt service obligations to the MDBs have recently become quite large. If one of these countries were to seek debt relief, the MDBs might have to provide such relief. In addition, the proposals for new instruments to encourage more cofinancing by commercial banks with MDBs raise questions about the treatment of both bank and MDB loans when the borrower seeks debt relief. If debt relief is sought from creditor MDBs, should the USG consider changing its policy of supporting the exemption of MDBs from multilateral rescheduling operations? How do the evolving proposals for MDB co-financing impact on MDB and commercial bank participation in debt rescheduling?

2. In some recent cases, it appears that incomplete information on a country's external debt obligations has been an obstacle to formulating sensible policies on new lending or debt relief. The IMF, the IBRD and the BIS are the principle sources of information on international debt. Are there steps the USG and other creditors can take to improve the information base on international debt?

3. The USG has been pressed to participate in debt-relief negotiations before the debtor countries have concluded an arrangement with the IMF. Also, a second or third year of debt relief has been extended to countries even when they were not in compliance with their IMF arrangement. Should the USG continue to condition its participation in multilateral debt-relief negotiations on prior IMF Executive Board approval of a standby arrangement with the debtor country? What alternatives exist to multi-year debt-relief arrangements linked to compliance with an IMF arrangement?

D. East European Debt

Assessments of the debt-servicing capacity of East European countries are greatly complicated by the unusual trade and payments arrangements among these countries. Strong countries within the Bloc can "bail out" weak countries in ways that are difficult to identify. The requests for debt relief from Poland, Romania and Yugoslavia pose other unusual problems for official and private creditors. What steps can the USG take to ensure that the risks of lending to East European countries are properly assessed? Are special approaches necessary for dealing effectively with the debt-servicing difficulties of East European countries?

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